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**Raising relationships.(Using Predictive Modeling to Connect with
Customers)(customer service in the banking industry)(part 2)**

Johnson, John R.

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ABSTRACT:

Predictive modeling could be an effective strategy in establishing customer relationships. This anticipatory approach has increased revenues despite rare success rates compared to even-level marketing. The strategy was developed in the wake of one-to-one and relationship marketing wherein bankers realized the importance of determining what would be interesting for customers or the concept of the Next Logical Product.

TEXT:

Part one of this article appeared In the May 1999 issue of Bank Marketing. There, John Johnson examined the two-part nature of branding, the difference between brand recognition and recall, and the ways banks can build better customer relationships. He also explored how event-level marketing strategies can help institutions connect with customers in more compelling ways.

In part two of the article, Johnson discusses the predictive modeling, another approach to building solid relationships with customers. One thing leads to another.

In most contexts, it's the language of exasperation.

But in terms of building customer relationships and marketing financial products and services, That's exactly what You want to happen. One thing leads to another.

For bank marketers, This amounts to the good version of the Domino Theory:

Current needs morph into new ones; present services multiply to keep pace.

One thing leads to another. Here's how to ensure that it does.

A brief history of predictive modeling

For some marketers, the idea of the Next Logical Product has become synonymous with state-of-the-art targeted marketing. The ascendancy of customer-centric marketing, one-to-one marketing and relationship marketing has encouraged banks to view the Next Logical Product as critical to the success of their business strategies and tactics. But what is it, exactly?

Historically, banks promoted products individually, in large, product-centered campaigns. These promotions were frequently based upon statistical simulations of each customer's likelihood to purchase a specific product. Put simply, those customers with the strongest predicted predilection for a product received a solicitation.

With the advent of one-to-one and relationship marketing, bankers became less obsessed with the efficiency of single-product campaigns and more concerned about building relationships with customers. They came to believe that marketing products that appealed to individual clients best built such relationships. The challenge became how to determine if a client was interested in a specific product. Thus, predictive modeling was born.

This approach is somewhat different from the event-level marketing discussed in part one of this article (Bank Marketing, May 1999). Predictive modeling is anticipatory, while event-level marketing is

reactive. In event-level marketing, the customer must engage in some overt action that triggers contact from the bank. Even though predictive modeling rarely - if ever - has success rates as high as those of event-level marketing, revenues from predictive modeling are incremental. And realizing revenue from a relatively inexpensive source makes good business sense.

Banks and other industries soon adopted formal models of customer-behavior to determine which products their customers were most likely interested in, and, thus, which products the bank should be promoting. The new goal is for bank customers to see fewer messages about products and services that don't interest them, and more messages about those products and services that they need. The process of ensuring that this happens is called the Next Logical Product method.

The Next Logical Product

Although simple in concept, the Next Logical Product is a complex combination of statistical models that transforms a comprehensive product focus into a customer-oriented approach. In order to develop a Next Logical Product (or Service) strategy, a bank would run each of its households through formal models of customer behavior for ownership (or purchase or response - if there are available data) of each product/service. The level of specificity for each product or service is important, so the process is not crowded with superfluous offerings.

Although the details of the statistical modeling are beyond the scope of this article, a general discussion of the process is necessary. The first step in developing a predictive model is to synchronize the bank's product offerings with the way customers view bank products. It is critical that the products the bank is analyzing are representative of the way a bank customer sees banking products, not the way bankers view them.

For example, ten or twenty different checking accounts, all based on an add-on package offering, is not the way customers view checking accounts. In order to establish a workable number of models, a reasonable approach would be to focus on products that come from the bank's MCIF P-type categories - assuming the bank has a customer-oriented P-type classification.

For this discussion, let's assume that the bank has 12 product categories (interest checking, non-interest checking, savings, money market, certificates of deposits, individual retirement accounts, credit cards, collateralized loans, unsecured loans, mortgages, insurance and trust.) Once synchronization has occurred, the probability of response or ownership is calculated for each individual product.

These product-based probabilities for each household in the database are comparable across all models. In other words, if the probability score for an interest-bearing transaction account was higher for a given household than a collateralized loan, the likelihood of successfully selling an interest-bearing checking account would be higher than selling a collateralized loan.

At the end of this modeling process, a bank will know the likelihood of any household purchasing any of the offered products and services. These probabilities are sorted in descending order for each household. The first account in the sort list for each household (that account with the highest probability or highest likelihood) is the Next Logical Product for that household.

Once the bank knows which product a customer is likely to be interested in, it can specifically market to the household. At this stage, some marketers consider the bank to be taking a holistic approach in regard to the customer. And they see the institution as customer-centric. But simply stopping at this point ignores the shareholders' stake in the equation.

By not incorporating profitability in its modeling, the bank may be selling products to unprofitable customers. Profitability is a critical-but-frequently overlooked component of predictive modeling. Estimated profit must be constructed for each account type modeled for

purchase. Each account in the probability model should also feature estimated profitability for each household. Both the estimated profitability and probability-of-purchase are needed to make sound strategic decisions.

Estimated profitability is the result of more statistical modeling. This time, however, the object is to determine the account behavior (balance, transactions, etc.) that can be expected if a specific household purchased a specific account. While the details of this process are too complex for the scope of this discussion, a brief overview is necessary.

Five-part profitability

Profitability in banks is comprised of many parts. In general, the five essential ones are: net interest revenue, other revenue, direct expenses, indirect expenses and risk provision.(1)

Many of the components, such as balance, fees, service charges, transactions and account life-span can be estimated. The results of profitability modeling are not binary, as with the response or ownership areas discussed earlier. Instead, it yields a set of values that can be used in profitability calculations.

Other revenue and expense components, such as expense allocations and risk, can be estimated through business modeling. The product of both kinds of modeling is estimated profit for each account (interest checking, non-interest checking, savings, etc.).

Once the probability-of-response and estimated profitability are available, they can be combined to form additional marketing intelligence. The product of the magnitude of gain or loss by the probability of that gain or loss actually occurring is the potential profit. This potential-profit figure incorporates profitability and response and increases the efficiency of targeting.

Because estimated profitability is available for each product a customer may purchase, it helps determine how many marketing dollars can be reasonably allocated to selling a specific product or service to a specific household. Combining probability-of-response and profitability helps eliminate the sale of unprofitable accounts. On the other hand, it helps eliminate the tendency to market those products that are profitable, but generally not needed.

Once the bank has a system for selecting the product that the customer is most likely to purchase at the highest profit level possible, the institution must get the specific products and incentives to the various touch-points.

Assuming the bank has done an effective job of positioning itself in the marketplace and with its customers, has established a way to identify a time when customers should be contacted and has established a methodology to predict customer needs - what's next?

How does it all fit together?

The answer to this is simple: Build a relationship by communicating with your customer. This specialized communication can follow three general paths:

The first path is a general media branding effort. Without recognition, other marketing efforts will be less-than-optimal. General media branding should be viewed as what banks want their customers to think when they think of their financial needs. In this approach, all other communications, direct mail, telemarketing, personal selling and marketing efforts should be tightly integrated and controlled.

The second path is timely institutional response to events in the customer's financial life. In the last issue of Bank Marketing, we looked at a customer who was in the process of closing down his entire relationship with a bank. What kind of message should this customer have received from his bank when his savings balance went to \$07 The one he did get, printed on his \$0 balance savings statement - two months after he withdrew all of his money from his savings account - was this:

YOUR ACCOUNT CURRENTLY HAS A ZERO BALANCE AND HAS BEEN INACTIVE SINCE

12-22-98. IF YOU WOULD LIKE YOUR ACCOUNT TO REMAIN OPEN, YOU SHOULD MAKE A DEPOSIT IMMEDIATELY OR NOTIFY YOUR LOCAL [bank name suppressed] BRANCH. OTHERWISE YOUR ACCOUNT WILL BE CLOSED AND YOU WILL NO LONGER RECEIVE A STATEMENT FROM US. THANK YOU FOR BANKING WITH [bank name suppressed.]

And when this same customer became frustrated in dealing with the bank's call center and withdrew a loan application, he received the following letter:

Thank you for your recent interest in a consumer loan from [bank name suppressed]. No further consideration will be given your application since you have requested that it be withdrawn.

If you have any questions regarding this letter, please contact your lender at the office listed below.

For a customer who is considering ending his banking relationship, how meaningful is it to be told that, in order to keep his savings account open, he should make a deposit immediately? A telephone call the day after the balance went to \$0 might have saved the account - and, by extension, the relationship. Perhaps there should have been even earlier contact, when the customer's end-of-month savings balance dropped 40 percent.

With regard to the other communication, how ambiguous is withdrawing a loan application and telling the sales person that you are making arrangements elsewhere? And yet, in all probability, this bank would describe itself as "customer-centric." While it is certainly in vogue to say this, the bank's actions suggest it is an entirely different sort of organization.

The third path is regular, relevant marketing efforts. Keep in mind that customers like to be sold - not hustled. Suggesting products to prospects that other, similar customers also own is not offensive. It is the reasonable development of business. And because of the favorable economies of scale that drive these kinds of efforts, they can generate substantial returns.

The key in building a relationship with your customers is to provide a value proposition that causes them to consider you as their financial service provider. Then monitor behavior, act in a timely fashion and anticipate needs.

Once the infrastructure, branding efforts and contact strategies are in place, it is critical that communications are integrated, so there are no mixed messages. To accomplish this, a "managed message" environment must be developed.

Control is exercised over the type of direct contact (mail, statement messages, ATM messages, etc.) that is used to contact the customer. The message itself is also controlled, regardless of whether it is in response to an event in the customer's relationship with the bank or as a result of predictive modeling. It should be ensured that the customer does not receive multiple messages in the same time frame.

In the current business climate, it is tempting to fashion a single solution to complex problems. Unfortunately, managing business relationships with customers is one of those multidimensional issues for which there is no one answer: a "silver bullet" does not exist. It is a climate, however, that is a business opportunity for those institutions with foresight and determination to develop truly lasting and profitable relationships with their clients. These kinds of relationships are constructed through constantly listening to the customer, regardless of whether he or she is speaking or communicating via actions.

Event-level marketing, examined last issue, and the Next Logical Product are driven by the availability of detail-level data, updated daily. It makes the detection of customer behavior and appropriate bank interaction/intervention possible. The availability of detail-level data also drives the predictive modeling, improving the efficiency and success of sales efforts.

The art of marketing

Once the "science" of marketing has been attended to, and the

statistical modeling and business-rule development has been finalized, one crucial step remains before the marketing message touches the customer.

How many times have hundreds-of-thousands - if not millions - of dollars been spent on sophisticated efforts to identify specific customers, only to then send them what is essentially a form letter? It's not unreasonable for a bank to believe that its most profitable customers are unique in their needs and unlike the rest of the institution's clients. But are profitable customers so similar in lifestyles and perspectives that no targeted communication is necessary? Of course not.

It is at this point that segmentation findings, demographic profiles and general account data are merged back into the information flow and used to develop a targeted message that is relevant to the customer [ILLUSTRATION FOR FIGURE 1 OMITTED]. It is critical to incorporate the knowledge banks have of their customers into the communications with them. A 65-year-old customer with \$20,000 in deposits and \$100,000 of investable assets is very different from a 40-year-old customer with \$20,000 in deposits and \$100,000 in investable assets.

Although the account behaviors of the 65-year-old and 40-year-old may be almost identical - and the product or service that would be appropriate for them is identical - their motivation for making that financial decision is probably very different.

If the bank does not take customer motivation into account, all of its early efforts may be for nothing. It is important to remember that although the science of marketing is very powerful, the buying decision is still a personal one. The art of marketing is, therefore, as crucial to closing a sale as the science. It is a costly error to treat all your customers the same - even if their accounts are similar.

Upon arriving at this realization, a bank can consider itself owning a state-of-the-art marketing process. Appropriately managing branding and imaging - and incorporating all customer touch-points with specific meaningful and relevant messages impacts a bank's bottom line.

Technology

The art and science of building customers relationships is a business dilemma, and the solution is driven by knowledge about individual customers compiled in databases.

Thus, it is appropriate to examine the investment in the information technologies needed to build customer relationships. Professors M. Bensaou and Michael Earl note that developing an IT strategy that perfectly mirrors the company's business strategy may be a fruitless exercise. Instead, they suggest using the Japanese philosophy of skipping strategy-alignment altogether and "[basing] technology investment decisions on easily quantifiable performance improvement goals."

It is tempting to invest in "technology for technology's sake" or to invest in technology only if it produces a predefined financial objective. But the importance of managing customer relationships is of such strategic importance that old ROI metrics may not be appropriate. A more realistic way of testing the viability of a technology investment is to determine the payoff of existing or proposed performance goals if they could be reached, and then selecting the technology that allows those goals to be met. (2)

In short, business objectives should drive the technology decisions. If the technology will support meeting the business objectives, then it is a viable option. This is a particularly salient way to approach data warehouses. The managers charged with implementing data warehouses - which, by the way, are crucial to Next Logical Products and event-level marketing efforts - frequently have fixations on size. It is not uncommon for a banker to be quoted in the financial press commenting on the storage capacity of their new data warehouse, the anticipated future impact, the number of systems that it sources and the years that the effort took.

What is less common is comments on how the data warehouse is quantifiably impacting the bottom line. Even rarer are estimates on how quickly data warehouses begin to contribute to meeting business objectives.

Taking a business-objective approach to deploying a data warehouse should ameliorate the chances of quick success and minimize spurious data that contribute little to the roll-out of a data warehouse.

It should be clear to banks that a "silver bullet" with regard to gaining customer mind-share does not exist. Managing these relationships is a complex business issue that is built upon sophisticated computer hardware, software, statistical analysis, business rules and programming.

However, at the heart of all this is a business issue: How can I positively impact my bottom line? The answer is an incremental process of continual improvement. The key here is to establish specific business objectives and work toward them, while generating returns.

With the focus on quarterly profit, anything less is intolerable to the shareholders.

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1 Cliff Baggett, CPA, "Presentation of NCR's "Five Factor Atomic Profit Metric" to The Brazilian Bankers Association and Brazilian banks", Sao Paulo, Brazil, Week of August 24, 1998.

2 M Bensaou and Michael Earl, "The Right Mind-Set For Managing Information Technology", Harvard Business Review, September-October, 1998, pp. 120-124.

John R. Johnson is a senior business consultant in customer management solutions with a large technology company. He can be reached at (704) 509-9501.

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